No. 9883

In the United States Circuit Court of Appeals for the Ninth Circuit

PARMER A. GILLESPIE, EXECUTOR, ESTATE OF MAUD GILLESPIE, DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The only previous opinion in the present case is that of the United States Board of Tax Appeals (R. 142), which is reported in 43 B. T. A. 399.

JURISDICTION

The appeal in this case involves income taxes for the year 1935 in the amount of $549.76, and is taken from a decision of the Board of Tax Appeals entered on March 20, 1941. (R. 160.) The case is brought to this Court by a petition for review filed on June 19, 1941 (R. 161–166), pursuant to Sections 1141 and 1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

In 1929 when the taxpayer was 57 years old she and her husband entered into an agreement with a corporation, whereby they transferred property which they owned jointly with a value of about $1,400,000, in part consideration for which the corporation agreed to pay her $15,000 per year for life and guaranteed to her also that she should receive annually as dividends an amount equal at least to $10,000. The amount a reputable life insurance company would have charged her for an annuity of $25,000 is $327,000, which the Board decided was the cost of the annuity. The questions presented are:

1. Whether the agreement between the taxpayer and her husband, on the one side, and the corporation on the other was a contract of sale or a contract for an annuity.

2. If the contract was for an annuity, whether $327,000 represented the cost of the annuity.

3. Whether Section 22 (b) (2) of the Revenue Act of 1934, as applied to the facts of this case, violates the Fifth and Sixteenth Amendments.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra,* pp. 23–26.

STATEMENT

The facts, some of which were stipulated, as found by the Board of Tax Appeals (R. 144–150), are substantially as follows:

Taxpayer was an individual residing at 712 North Roxbury Drive, Beverly Hills, California. She was born on June 9, 1872,[1] and was married to Frank A. Gillespie, born August 27, 1868, in 1892. They had three sons, B. A. Gillespie, L. A. Gillespie, and P. A. Gillespie, and six grandchildren. (R. 144.)

On April 4, 1920, F. A. Gillespie & Sons Company, a corporation, hereinafter called the company, was organized under the laws of Oklahoma, with a capital stock of $1,000,000, divided into 10,000 shares of the par value of $100 each. The shares were issued 9,980 to F. A. Gillespie and five each to taxpayer and B. A. Gillespie, L. A. Gillespie, and P. A. Gillespie. By an instrument executed on February 9, 1921, F. A. Gillespie, in consideration of the fact that equitable title to some of the properties transferred to the company for the issuance of its stock to him had theretofore been conveyed to taxpayer and B. A. Gillespie, L. A. Gillespie, and P. A. Gillespie, thereby declared that he held 9,975 of the shares of the company in trust in equal shares for the four named individuals and F. A. Gillespie. The trust term was limited to the life of the last surviving beneficiary and the corpus was made distributable among the surviving children or grandchildren of taxpayer and F. A. Gillespie or among their heirs. (R. 144.) The beneficiaries were entitled to receive currently all dividends paid on the stock and accretions thereto. On the death of tax-

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[1] After petition for review of the Board's decision had been filed in this Court taxpayer died in September 1941. Parmer A. Gillespie, her executor, was substituted as petitioner by order of this Court in October 1941.

payer or F. A. Gillespie within the trust period, the surviving children were to become entitled to the current distributions and on their death similarly within the term of the trust this right was to pass to the grandchildren. The trustee was given broad powers of management and investment, and surviving trustees were designated (R. 144–145).

Taxpayer and F. A. Gillespie on May 15, 1929, entered into two agreements by the first of which, after reciting that they were living separate and apart and wished to settle their rights in their properties, they agreed mutually on the disposition of the property which they owned jointly and released each other reciprocally of all claims for support or inheritance. With the exception of certain personal and real property which was set aside for the contractors individually, the bulk of the property, it was agreed, was to be conveyed to the F. A. Gillespie & Sons Company. By the terms of the second agreement, which was executed by taxpayer, F. A. Gillespie, and the company, the two first named conveyed to the company the following property, of the values indicated, which they owned jointly (R. 145):

U. S. First Liberty Loan bonds and Port of New Orleans, Louisiana, state bonds	$1,172,000.00
Empress Building, Tulsa, Oklahoma	150,000.00
Sundry lands and lots located in Oklahoma	22,512.00
Cash and accounts receivable	94,365.22
Sundry stocks	25,363.00
Total	$1,464,240.22

The cost of the above property to F. A. Gillespie and taxpayer equaled or exceeded the above fair market value (R. 146).

As part consideration for the conveyance of these properties the company agreed to pay to F. A. Gillespie and taxpayer, each respectively, the sum of $15,000 per year for life and guaranteed to taxpayer, in addition, that she should receive annually as dividends an amount equal at least to $10,000. If funds were not available for the declaration of dividends in this amount, the company agreed to pay such sum to the taxpayer. F. A. Gillespie agreed in addition that he would not sell any of the shares of the company which he held in trust without the consent of a majority of the company's directors (R. 146).

The conveyances of property by taxpayer to F. A. Gillespie & Sons Company in accordance with such tripartite agreement were made for two purposes, namely, first, as a purchase of the specified annuity to herself during her life, to the extent of the fair cost thereof, and, secondly, as a gift of the excess of the value of such properties over such cost for the benefit of her children and grandchildren (R. 146).

At a meeting of the board of directors of the company duly called on February 18, 1932, the contract executed by the company on May 15, 1929, under which the parties had been acting, was adopted and ratified in view of the fact that "the acquisition by this Company of the properties and assets referred to in said contract are [sic] of great value and largely in excess of the amounts provided to be paid under the terms of said contract by this corporation." It was acknowledged by further resolution of the directors that the company had received all the properties agreed to be transferred to it under the contract (R. 146–147).

On the same date, February 18, 1932, deeds transferring the realty identified above as the Empress Building, and the Gillespie residence in Tulsa, included above in sundry Oklahoma lands, were executed to the company. A final deed covering lands agreed to be conveyed in Oklahoma was executed on June 25, 1934 (R. 147).

During the year 1932 taxpayer and the company became involved in certain litigation in which the company asserted a claim for debt against taxpayer in the amount of $17,845.05. This controversy was settled by the taxpayer's agreement to pay the company one-half of this claim, less certain minor deductions, out of the $10,000 which should become due to her from the company on May 15, 1932, and by the transfer to the company of certain realty in Santa Monica, California, owned by taxpayer. The company agreed to pay to taxpayer at once $10,000 owed by it under the contract less $2,000 for attorney's fees and $2,000 already paid to taxpayer (R. 147).

On June 22, 1932, certain lots of real property of undetermined value owned by taxpayer and located in Santa Monica, California, were transferred to the company (R. 147–148).

Taxpayer, on November 16, 1933, in view of the depleted financial condition of the company, agreed to the suspension of the dividend payments of $10,000 annually for three years or for such shorter period as the company was unable to make them. This agreement was made contingent on the suspension by F. A. Gillespie of his right to receive $10,000 annually from the company, the funds thereby freed to be used in

building up the concern. It was also made contingent on the payment to taxpayer of one-half of the "net refund on Federal taxes" received by F. A. Gillespie in December 1932. It was stated that taxpayer owned a building in Los Angeles, a $15,000 second mortgage on which she was obligated to discharge at the rate of $2,500 annually, and that the funds to be received from F. A. Gillespie were to be applied on this obligation (R. 148).

The following payments were made under the agreement of May 15, 1929, by the company to taxpayer and F. A. Gillespie on the dates indicated (R. 148):

	Petitioner	*Gillespie*
1932	$34,894.01	$54,375
1933	25,000.00	15,000
1934	20,000.00	15,000
1935	17,666.25	-------
1936	19,000.00	-------
1937	15,000.00	-------
1938	15,000.00	-------
1939	15,000.00	-------

Of the amounts paid in 1932, $15,394.01 received by taxpayer and $39,375 received by F. A. Gillespie represent adjustments of amounts remaining due under the contract for the years 1929, 1930, and 1931 (R. 149).

Of the amount received by taxpayer during 1935, the taxable year, $2,666.25 is noted on the books of the company as a loan. However, taxpayer did not sign a note nor give security for this amount. No interest was agreed on and up to the time of the hearing in this proceeding no payment of principal or interest had been made (R. 149).

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An annuity upon the life of a male individual born in the United States on August 22, 1868, which would have paid $15,000 per annum to him for his life could have been purchased from a reputable life insurance company doing business in the United States on May 15, 1929, for the sum of $153,750 (R. 149).

An annuity upon the life of a female individual born in the United States on June 9, 1872, which would have paid the sum of $15,000 per annum to her for her life could have been purchased from a reputable life insurance company doing business in the United States on May 15, 1929, for the sum of $196,537.50. An annuity upon the life of a female individual born in the United States on June 9, 1872, which would have paid the sum of $20,000 per annum to her for her life could have been purchased from a reputable life insurance company doing business in the United States on May 15, 1929, for the sum of $262,050. An annuity upon the life of a female individual born in the United States on June 9, 1872, which would have paid the sum of $25,000 per annum to her for her life could have been purchased from a reputable life insurance company doing business in the United States on May 15, 1929, for the sum of $327,562.50 (R. 149–150).

The Commissioner asserted a deficiency on the ground that the entire amount of $17,666.25 which the taxpayer received from the company during the taxable year should have been included in her income, presumably on the ground that the cost of the annuity was about $700,000, and under Section 22 (b) (2) of

the applicable revenue act 3% of $700,000 or about $21,000 out of the annual payments of $25,000 should be included in gross income. Since the payment for the taxable year was only $17,666.25 all of that sum would be included in the taxpayer's income. The Board of Tax Appeals decided, however, that the cost of the annuity was what a reputable life insurance company would have charged the taxpayer at her age in 1929, when the contract was made, which was about $327,000, and that $9,826.88, representing 3% of the actual cost of such an annuity, should be included in gross income. The Commissioner did not file the cross appeal and therefore has acquiesced in the Board's determination that the cost of the annuity was about $327,000, instead of $700,000.

SUMMARY OF ARGUMENT

1. In 1929 when the taxpayer was 57 years old, she transferred property worth about $700,000 to a corporation in consideration of its promise to pay her $25,000 a year for the rest of her life. Inasmuch as the amount to be paid by the company depended upon the life of the taxpayer, and might be as little as several hundred dollars or as great as $750,000, the contract could not reasonably be construed as a contract of sale but rather as a contract for an annuity. The Treasury regulations provide that amounts received under an annuity include amounts received in periodic installments, whether annually or semiannually, for life. The courts have also defined an annuity as a sum paid yearly or at other specified intervals in return for the payment of a fixed sum by the annuitant.

Since the contract in question provides that the taxpayer should receive $25,000 a year for life, the Board correctly determined that the contract was for an annuity and not a contract of sale.

2. At the hearing before the Board of Tax Appeals the Commissioner maintained that the cost of the annuity in question was about $700,000, which was the value of the property transferred by the taxpayer to the company. But the Board determined that the cost was what a reputable life insurance company would have charged for an annuity of $25,000 per year for a woman of the taxpayer's age, which was about $327,000, and that the balance of the consideration paid by the taxpayer was a gift. The Commissioner did not file a cross appeal from the Board's decision so that he is precluded from asking this Court to find that the cost was in excess of the amount determined by the Board.

However, the taxpayer's personal representative contends that the cost of an annuity of $15,000, or about $196,000, is the correct cost. The basis for this argument is that in 1933 the taxpayer agreed to suspend the payment of $10,000 by the company for a period of three years. But the contract was made in 1929, and it expressly provided that the taxpayer should receive at least $25,000 per year for her life. What she did in later years in regard to the annual payments is immaterial. The cost was fixed when the contract was executed in 1929.

3. The taxpayer's personal representative argues that Section 22 (b) (2) violates the Sixteenth Amend-

ment because until the consideration paid for an annuity is recouped, all payments under the contract are a return of capital. It is impossible to demonstrate that all payments under an annuity contract are a return of capital and Congress had a sound basis for the premise that a portion of each annuity payment in fact constitutes income. Congress fixed the rate of three percent of the cost of the annuity because it approximated the rate of return in the average annuity. In a case under the same statute involving similar circumstances, the Seventh Circuit has upheld the validity of the statute. The cases relied upon by the taxpayer's personal representative are distinguishable.

ARGUMENT

I

The agreement of May 15, 1929, between the taxpayer and her husband and the company was a contract for an annuity and not a contract of sale

The petitioner's decedent, hereafter called the taxpayer,[2] was born in June 1872. She and her husband had three sons and six grandchildren. In April 1940, F. A. Gillespie and Sons Company, a corporation hereafter called the company, was organized under the laws of Oklahoma with a capital stock of $1,000,000 (R. 144).

The taxpayer and her husband in May 1929, entered into two agreements, the first of which, after reciting

[2] The taxpayer died in September of 1941 and her executor was substituted in her place by order of this Court, dated October 10, 1941.

that they were living apart and wished to settle their rights in their property, stated that they agreed mutually on the disposition of the property which they owned jointly. The bulk of the property was to be conveyed to the company by the terms of the second agreement which was executed by the taxpayer, her husband, and the company. The taxpayer and her husband conveyed to the company property with a value of about $1,400,000 (R. 145).

As part consideration for the conveyance of these properties the company agreed to pay to the taxpayer and her husband each, respectively, the sum of $15,000 per year for life and guaranteed to the taxpayer in addition that she should receive annually as dividends an amount equal at least to $10,000. Paragraph 1 of that agreement provides in part (R. 29):

> In consideration thereof, the Corporation agrees to pay to the Husband and Wife each, respectively, the sum of Fifteen Thousand ($15,000) Dollars per year, as long as they respectively live, and in addition thereto to pay to the said wife, dividends in at least the sum of Ten Thousand ($10.000) Dollars per year, and if for any reason funds are not available to be paid as dividends in the manner herein indicated, then in that event the Corporation agrees to pay to the said Maud Gillespie herein called the Wife, the sum of Ten Thousand Dollars ($10,000) per year, *it being the purpose and intention of this agreement that the Corporation pay to the said Maud Gillespie in cash at least the sum of Twenty-five Thousand ($25,000) Dollars per year hereafter.* [Italics supplied.]

In November 1933 the taxpayer, in view of the depleted financial condition of the company, agreed to the suspension of the dividend payments of $10,000 annually for three years or for such shorter period as the company was unable to make them. The payments made to the taxpayer in the taxable year by the company aggregated $17,666.25 (R. 148).

An annuity upon the life of a female individual born in the United States on June 9, 1872, which would have paid the amount of $25,000 per annum to her for her life could have been purchased from a reputable life insurance company doing business in the United States on May 15, 1929, for the sum of $327,562.50 (R. 150).

Section 22 (b) (2) of the Revenue Act of 1934, Appendix, *infra*, p. 23, provides in part that amounts received as an annuity under an annuity contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to three percent of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under the 1934 income tax law or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such an annuity.

The purpose of this statutory provision is explained in the Congressional Committee Reports which are set forth in the Appendix, *infra*, p. 24. These reports show that the prior Act (the 1932 Act) did not tax annuities arising under contracts until the annuitant

had received an aggregate amount of payments equal to the total amount paid for the annuity. The reports explained that payments to annuitants are in fact based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost and in addition thereto a low rate of return on his investment. The reports also said that the change in the 1934 Act continued the policy of permitting the annuitant to recoup his alleged cost tax-free but required him to include in his gross income a portion of the annual payments in an amount equal to three percent of the cost of the annuity. The reports set forth that while the percent used was arbitrary, it approximated the rate of return in the average annuity.

The reports also state that statistics show that an increasing amount of capital was going into the purchase of annuities with the result that income taxes were postponed indefinitely. The change in the statute merely placed the return on this form of investment on the same basis as other forms of investment by taxing that portion of each payment which in fact constituted income.

Article 22 (b) (2)–2 of Treasury Regulations 86, relating to the Revenue Act of 1934, Appendix, *infra*, p. 23, provides that amounts received as an annuity under an annuity or endowment contract included amounts received in periodic installments whether annually, semiannually, quarterly, monthly or otherwise, and whether for a fixed period such as a term of years or for an indefinite period such as for life.

This definition of annuities in the Regulations clearly covers the contract between the taxpayer and her husband on the one hand, and the company on the other, providing for the payment of $25,000 per year for her life.

In *Bodine* v. *Commissioner,* 103 F. (2d) 982 (C. C. A. 3d), certiorari denied, 308 U. S. 576, an annuity was defined as "a sum paid yearly or at other specified intervals in return for the payment of a fixed sum by the annuitant."

In *Continental Illinois Bank & Trust Co.* v. *Blair,* 45 F. (2d) 345 (C. C. A. 7th), an annuity was defined as "an allowance or payment from the income of a fund at specific periods and during a prescribed term." In that case the taxpayer delivered to certain charitable institutions stocks and bonds to the amount of $350,000 and received in return their obligations to pay him at stated times certain sums of money during a prescribed period. The Court held that these sums were purchased annuities and under the statute then in force they were exempt until the purchase price had been returned.

See also *Raymond* v. *Commissioner,* 114 F. (2d) 140 (C. C. A. 7th), certiorari denied, 311 U. S. 710.

Since under the contract of May 15, 1929, the company agreed to pay the taxpayer, who was 57 years old at the time, at least $25,000 per year for the rest of her life, the contract seems to fit the definition of an annuity contract laid down in the treasury regulations and in the court decisions mentioned above. If the contract was merely a contract of sale, it is difficult

to explain the absence of a definite selling price. The annuities might have amounted to as little as a few hundred dollars, or to as great an amount as $750,000, depending upon the life of the taxpayer. There is no evidence to show that the taxpayer reported gain or loss in the year 1929 when the contract was executed.

The taxpayer argues that the company had no authority under the law of Oklahoma to enter into a contract for an annuity (Br. 19–21). We are not concerned with the validity of the contract in this case. It is sufficient for our purposes that the company did enter into such a contract. See *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 562.

II

The Board correctly determined the cost of the annuity

Article 22 (b) (2)–2 of Treasury Regulations 86, Appendix, *infra,* p. 23, illustrates the statute with this example: "A" bought in 1933 for $50,000 consideration a life annuity payable in annual installments of $5,000. For the calendar year 1934 he would be required to include in gross income $1,500 of the $5,000 received during that year (three percent of $50,000), $3,500 being exempt. If "A" should live long enough to receive as exempt $50,000, then all amounts he receives thereafter under the annuity contract would be included in gross income.

At the hearing before the Board of Tax Appeals, the Commissioner took the position that the cost of the annuity to the taxpayer was about $700,000, representing her share of the property transferred to the

company in consideration of the annuity. If the Commissioner had been upheld by the Board of Tax Appeals, the entire amount received by the taxpayer during the taxable year, namely, $17,666.25, would have been included in gross income because three percent of $700,000 (as provided by Section 22 (b) (2)) would have been in excess of $17,666.25. But the Board of Tax Appeals decided that the cost of the annuity was $327,562.50, representing the amount a reputable life insurance company would have charged the taxpayer at her age in May 1929, for an annuity of $25,000 per year, and that the balance of the sum of about $700,000 was either a gift to her children and grandchildren or a contribution to the corporate capital. Under this holding, $9,826.88 (representing three percent of $327,562.50) out of the $17,666.25 received during the taxable year, was included in her gross income. The Commissioner acquiesced in this part of the Board's decision and did not file a cross appeal and so attempt to include all of the $17,666.25 in taxpayer's gross income.

On this appeal, the petitioner contends that the Board should have determined the cost of the annuity to be about $196,000 (the cost to the taxpayer of an annuity of $15,000 per year), instead of about $327,000 (the cost of an annuity of $25,000 per year) (Br. 57–61). Of course, that would reduce the taxable income to about $5,800 (three percent of about $196,000) instead of about $9,800. The petitioner contends that the taxpayer purchased two annuities, one for $15,000 per year and another for $10,000 per year, and that

she received nothing from the latter during the taxable year. The Board correctly construed the contract of May 15, 1929, as guaranteeing the taxpayer an annuity of $25,000 per year because the consideration for the annuity was a lump sum and the contract expressly recited that it was the intention of the agreement that the taxpayer should receive at least $25,000 per year in cash from the corporation. Paragraph 1 of the agreement provides in part (R. 29):

> * * * In consideration thereof, the Corporation agrees to pay to the Husband and Wife each, respectively, the sum of Fifteen Thousand ($15,000) Dollars per year as long as they respectively live, and in addition thereto to pay to the said wife, dividends in at least the sum of Ten Thousand ($10,000) Dollars per year, and if for any reason funds are not available to be paid as dividends in the manner herein indicated, then in that event the Corporation agrees to pay to the said Maud Gillespie herein called the Wife, the sum of Ten Thousand Dollars ($10,000) per year, *it being the purpose and intention of this agreement that the Corporation pay to the said Maud Gillespie in cash at least the sum of Twenty-five Thousand ($25,000) Dollars per year hereafter.* [Italics supplied.]

The Board said in its opinion (R. 157–158):

> The $25,000 figure must be taken in preference to the $15,000 sum contended for by petitioner, since the former amount was that for which the properties were transferred. Subsequent relinquishment of a portion of the an-

nuity can not alter the determination of the amount which was transferred under the 1929 contract as consideration for the annuities receivable by petitioner. No argument is made, it should be noted, that the $10,000 guarantee of the dividends to be received annually by petitioner did not in itself constitute an annuity. Both parties seem to concede that it falls in a class with the $15,000 annuity and we have so treated it.

III

Section 22 (b) (2) of the Revenue Act of 1934 as applied to the facts of this case does not violate the fifth or sixteenth amendments to the Constitution

The principal contention of the taxpayer's personal representative in regard to the constitutionality of Section 22 (b) (2) is that in any case where the beneficiary of an annuity contract has not received back annuity payments equalling the consideration paid for the contract, the requirement that a portion of the annuity payments (i. e., so much as is not in excess of three percent of the consideration paid for the contract) must be included in gross income, imposes a direct tax upon capital rather than a tax upon income.

The argument is based on the fallacious premise that until the consideration paid for an annuity contract is recouped, all payments under the contract are a return of capital. This is plainly not the case, as pointed out in the House and Senate Committee Reports on the 1934 Act (*infra*, pp. 24–26), "Payments to annuitants are, in fact, based upon mortality tables

which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost and in addition thereto a low rate of return on his investment." Section 22 (b) (2) is designed to tax that portion of each annuity payment which does in fact constitute income. However, because it would be almost impossible to determine the precise amount of income which is included within any particular annuity payment, Congress fixed three percent of the cost of the annuity as the amount to be treated as income; it recognized that "While the percent used is arbitrary, it approximates the rate of return on the average annuity" (*infra*, p. 25).

None of the authorities cited by the taxpayer's personal representative (Br. 38–49) throws any doubt upon the validity of Congressional action in this respect. In *Burnet* v. *Logan,* 283 U. S. 404, upon which the taxpayer's personal representative chiefly relies, the taxpayer had sold shares of stock in a company engaged in mining ore for cash and a royalty for each ton of ore thereafter mined. The Supreme Court held that the taxpayer was not subject to income tax upon any of the royalties until they exceeded her cost basis. The case is clearly distinguishable, because the *Logan* case involved no statute corresponding to Section 22 (b) (2). The only court which has passed upon the constitutionality of Section 22 (b) (2) of the Revenue Act of 1934, is the Circuit Court of Appeals for the Seventh Circuit. In *Raymond* v. *Commissioner, supra,* the taxpayer transferred to certain charitable and educational institutions securities valued at about

$1,200,000 in return for payment to her of $62,500 each year of her life. An annuity for a corresponding amount would have cost the taxpayer about $528,000. The taxpayer contended that Section 22 (b) (2) of the Revenue Act of 1934 was unconstitutional as applied to the facts of that case because she had not yet recouped, through annuity payments, the entire consideration she paid for the annuities. The court held that the statute was valid as applied to the facts of that case.

A close analogy to the present case is to be found in Section 44 (a) of the Revenue Act of 1934, which provides that any person who regularly sells personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year, which the gross profit realized or to be realized when payment is completed, bears to the total contract price. The vendor in the case of an installment sale, like the annuitant here, does not immediately recoup his capital and there is a possibility he may never recoup it. Yet the validity of the provision for treating a portion of each installment payment as income has never been questioned. Cf. *Pacific National Co.* v. *Welch,* 304 U. S. 191; *Nuckolls* v. *United States,* 76 F. (2d) 357 (C. C. A. 10th); *Lawler* v. *Commissioner,* 78 F. (2d) 567, decided by this Court.

The taxpayer's personal representative argues that of the sum of $17,666.25 received by the taxpayer from the company in the taxable year, $2,666.25 represented a loan. (Br. 50–56.) We believe this question is im-

material under the circumstances of this case, because the Board of Tax Appeals has decided that only $9,826.88 (three percent of $327,562.50) out of the total payment of $17,666.25, received by the taxpayer from the company, should be included in gross income. For the purposes of this tax year, it does not make any difference whether the sum was a loan or not. If the question becomes important in any tax year between 1936 and 1941, when the taxpayer died, the question may be considered at that time.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should therefore be affirmed.

Respectfully submitted,

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DECEMBER 1941.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

*   *   *   *   *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:

*   *   *   *   *

(2) *Annuities,* etc.—* * * Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this title or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. * * *

(U. S. C., Title 26, Sec. 22.)

Treasury Regulations 86, relating to the Revenue Act of 1934:

ART. 22 (b) (2)–2. *Annuities.*—Amounts received as an annuity under an annuity or endowment contract include amounts received in periodical installments, whether annually, semi-annually, quarterly, monthly, or otherwise, and whether for a fixed period, such as a term of years, or for an indefinite period, such as for

life, or for life and a guaranteed fixed period, and which installments are payable or may be payable over a period longer than one year. * * * As soon as the aggregate of the amounts received and excluded from gross income equals the aggregate premiums or consideration paid for such annuity, the entire amount received thereafter in each taxable year must be included in gross income. The provisions of this article may be illustrated by the following examples:

Example (1): A bought in 1933, for $50,000 consideration, a life annuity, payable in annual installments of $5,000. For the calendar year 1934 he would be required to include in gross income $1,500 of the $5,000 received during that year (3 percent of $50,000), $3,500 being exempt. If A should live long enough to receive as exempt $50,000, then all amounts he receives thereafter under the annuity contract would be included in gross income.

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Congressional Committee Reports, relating to Section 22 (b) (2) of the Revenue Act of 1934:

H. Rep. No. 704, 73d Cong., 2d Sess., p. 21 (1939–1 Cum. Bull. (Part 2) 554, 569):

SECTION 22 (b) (2). *Annuities, etc.*—The present law does not tax annuities arising under contracts until the annuitant has received an aggregate amount of payments equal to the total amount paid for the annuity. Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost and in addition thereto a low rate of return on his investment. The change continues the policy of permitting the annuitant to recoup his original cost tax-free but requires him to include in his gross income a portion of the annual payments in an amount equal to 3 percent

of the cost of the annuity. While the percent used is arbitrary, it approximates the rate of return in the average annuity.

Statistics show that an increasing amount of capital is going into the purchase of annuities, with the result that income taxes are postponed indefinitely. The change merely places the return of this form of investment on the same basis as other forms of investment by taxing that portion of each payment which in fact constitutes income.

S. Rep. No. 558, 73d Cong., 2d Sess., p. 23 (1939–1 Cum. Cum. Bull. (Part 2) 586, 604):

Section 22 (b) (2) Annuities

The present law does not tax annuities arising under contracts until the annuitant has received an aggregate amount of payments equal to the total amount paid for the annuity. Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost, and in addition thereto, a low rate of return on his investment.

The House bill continues the policy of permitting the annuitant to recoup his original cost tax-free, but requires him to include in his gross income a portion of the annual payments in an amount equal to 3 percent of the cost of the annuity. While your committee is in agreement with the change made by the House, it was thought advisable to continue the policy of not taxing any portion of the amount received from an annuity until the aggregate amount of payments equal the total amount paid for the annuity in cases where the aggregate amount received by the annuitant from all his annuities is not more than $500. The following example illustrates the change made:

Example: "A", an individual, received during the calendar year the following amounts from annuities: annuity no. 1, $450; annuity no. 2, $300; and annuity no. 3, $150. In the case of annuity no 1, "A" prior to 1934 received aggregate payments equal to the aggregate premiums paid. In the case of annuity no. 1, "A" reports the entire amount of the annuity because all of his capital has been returned. In the case of annuity no. 2 and annuity no. 3, "A" is required to include in gross income 3 percent of the consideration paid for each such annuity. The $500 exemption will not apply in such a case because the total annuity payments received by "A" during the taxable year exceed that amount.

H. Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 627, 628):

Amendment No. 14.—The House bill requires an annuitant to include in his gross income a portion of the annual receipts in an amount equal to 3 percent of the cost of the annuity. The Senate amendment excepts from the House change persons whose aggregate receipts from annuities in the year do not exceed $500, and makes some minor changes in phraseology. The House recedes with an amendment rejecting the $500 exception.

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